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COMMENT LETTER

Date

21 June 2009

To

International Accounting Standards Board 30 Cannon Street London EC4M 6XH

By email commentletters@iasb.org

Dear Sir

Discussion Paper: Preliminary Views on Revenue Recognition in Contracts with Customers

We are pleased to comment on the above Discussion Paper, on behalf of BDO International¹. Our detailed comments are set out in the attached appendices.

We welcome the IASB's proposal to develop a single contract-based revenue recognition model. We are supportive of the aim to reduce the number of standards relevant to revenue recognition under US GAAP and also the plan to introduce in to IFRSs additional guidance on the identification and treatment of multiple-element arrangements. The removal of inconsistencies in the treatment of economically similar arrangements within both GAAPs is also to be welcomed.

However, whilst we agree broadly with many of the proposals contained within the Discussion Paper, we are of the view that it contains insufficient detail and analysis to enable the Boards to proceed directly to an Exposure Draft. In consequence, we consider that, as a next step, the Boards should publish a second Discussion Paper that contains a clearer indication of the content and structure of any proposed Exposure Draft.

We are supportive of the Boards' decision to reject the more complex methods of measuring performance obligations which, we believe, would increase the risk of error and bring few benefits in respect of the majority of contracts to which the final standard is expected to apply. We do, however, have several reservations including in particular:

- the use of a definition of a contract that is different from that already provided in IAS 32;
- the detailed application of the concept of control which appears to focus mainly on physical possession of the asset rather than other less tangible qualities;
- the level of disaggregation that the definition of a performance obligation might require and its application in particular in complex design and construction projects;
- the potential that a 'standard' warranty would be treated as a separate deliverable rather than being considered simply as a guarantee that the primary asset is of saleable quality

We consider the development of a single contract-based revenue recognition model to be both desirable and achievable but are cautious about how in practice the proposals will be applied in

¹ BDO International is a world wide network of public accounting firms, called BDO Member Firms, serving international clients. Each BDO Member Firm is an independent legal entity in its own country.

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different sectors of the global economy. In consequence we would strongly recommend extensive field testing of the proposals over a number of industry sectors and geographical locations prior to the publication of an Exposure Draft. We also suggest that the field tests form the basis of illustrative examples, which should be included in the Exposure Draft, that show clearly how the principles should be applied in practice.

We hope that our comments and suggestions are helpful. Should you wish to discuss any of the points we have raised please contact either Tracey-Lee Massey at $+32\ 2\ 778\ 01\ 30$ or Andrew Buchanan at $+44\ (0)20\ 7893\ 3300$.

Yours faithfully,

BDO Global Coordination B.V.



Appendix 1 – Responses to specific questions

Chapter 2

Question 1: Do you agree with the Boards' proposal to base a single revenue recognition principle on changes in an entity's contract asset or contract liability? Why or why not? If not, how would you address the inconsistency in existing standards that arises from having different revenue recognition principles?

We agree with the Boards' proposal to base a single revenue recognition principle on changes in an entity's contract asset or contract liability.

However, as noted in our response to question 2, we do not think that it will be possible or advisable to cover all transactions resulting in income meeting the definition of revenue in a single standard (e.g. contracts within the scope of IAS 39, IAS 17, IAS 28 and IAS 31).

The application of a single revenue recognition principle in different industries and different countries will inevitably lead to the risk of a diversification in interpretation and application. In consequence, we consider it appropriate that any proposed standard includes illustrative examples, covering a number of industry sectors, that show clearly how and, critically, why the principles lead to a particular treatment.

We consider that basing the revenue recognition principle on changes in an entity's contract asset or contract liability is appropriate but that a better articulation is needed of why the measurement of the performance obligation is different, for example, from a financial instrument exit price measurement.

Question 2: Are there any types of contracts for which the Boards' proposed principle would not provide decision-useful information? Please provide examples and explain why. What alternative principle do you think is more useful in those examples?

The Boards' proposed principle would provide decision-useful information for the majority of contracts with customers. Our main concern is the effect the application of the requirements to contracts such as derivative financial instruments. In such contracts, the proposed measurement principles in particular would conflict with the requirements of IAS 39 which, inevitably, will provide more specific and relevant guidance than would be contained within a standard with broader scope.

We believe that, where an existing or proposed standard specifically addresses the accounting treatment of a transaction that may give rise to revenue, as is the case with contracts within the scope of IAS 39, IAS 17, IAS 28 and IAS 31 and as may result from the Boards' project on insurance contracts, these transactions should be scoped out of a general revenue recognition standard.

Notwithstanding the above point, we do not consider that the existence of volatility and uncertainty in contract outcomes should automatically lead to the conclusion that a contract type should be scoped out of a proposed revenue recognition standard. Uncertainty is inherent in many contracts with customers; this is particularly the case in terms of the cost of meeting contractual obligations over the course of a long-term contract and in agreements to provide goods which are subject to short-term fluctuations in price. Where contract terms are agreed at contract inception, the fluctuation in margin that would arise as a result of applying the basic principles described in this Discussion Paper provide, in our view, relevant information about the pricing and other decisions taken by management.

We would not necessarily seek to preclude the presentation of transactions that give rise to income but which might fall outside of the scope of the final general revenue recognition standard (e.g. rental income for a lessor) as revenue where that income would otherwise meet the definition of revenue. In some cases, however, we believe that the possibility of 'negative' revenue arising, as might be the case



should an IAS 39 fair value reduction be included in revenue, means that the presentation of such items as revenue should be prohibited.

Question 3: Do you agree with the Boards' definition of a contract? Why or why not? Please provide examples of jurisdictions or circumstances in which it would be difficult to apply that definition.

Whilst we do not disagree with the Boards' suggested definition of a contract, we do not believe that it is necessary to introduce a second definition of a contract into IFRSs. As there is no explicit definition of a contract within US GAAP, there would appear to be no impediment to including the existing IAS 32 definition in this standard.

We note that the proposed definition appears stricter than that used in IAS 32. Although the accepted interpretation of the IAS 32 is also strong, the use of the same definition would avoid the risk of any inconsistencies in application.

Chapter 3

Question 4: Do you think the Boards' proposed definition of a performance obligation would help entities to identify consistently the deliverables in (or components of) a contract? Why or why not? If not, please provide examples of circumstances in which applying the proposed definition would inappropriately identify or omit deliverables in (or components of) the contract.

We consider that the Boards' proposed definition of a performance obligation would help entities to identify consistently most of the deliverables in (or components of) a contract. However, in focusing only on promises in a contract, the definition does not make explicit the concept described in paragraphs 3.5 and 3.6 whereby a performance obligation might arise outside of the direct agreement between the entity and the counterparty, either through the operation of law or established practice. We recommend that the definition be amended to make this clear.

We agree in particular to the reference to the customer in the definition; this makes clear that the obligation is focused on what the customer receives rather than the activities undertaken by the entity delivering the good or service (a concept reinforced in paragraph 4.8). In our experience, much of the difficulty encountered when identifying the deliverables in a contract arises where the activities undertaken by the entity do not correspond with the benefits perceived by the counterparty in the transaction.

The indicators of a separate performance obligation suggested in paragraphs 3.11 (whether a good <u>could</u> be sold separately) and 3.37 (whether customers would pay additional consideration for that right) are useful in the context of a 'customers' perspective' approach when considered together.

We encourage the Boards to include these indicators in the proposed standard's application guidance. However, the application of the first indicator (whether a good <u>could</u> be sold separately) must be further clarified to prevent the separation of mutually dependent assets. To illustrate, in the example in paragraph 4.27 (a manufacturing process consisting of three pieces of equipment), it is suggested that equipment X, Y and Z are separate performance obligations because they <u>could</u> [our emphasis] be sold separately, even though EngineeringCo does not sell the equipment separately. In our view, X, Y and Z should not be treated as separate performance obligations if they are interdependent (e.g. where equipment X and Y cannot usefully function without equipment Z).

It may be the Boards' intention that the rebuttable presumption expressed in paragraph 4.56 would preclude the separate recognition of mutually dependent assets. If this is the case, we would recommend that the suggested wording is expanded to make this clear.



Question 5: Do you agree that an entity should separate the performance obligations in a contract on the basis of when the entity transfers the promised assets to the customer? Why or why not? If not, what principle would you specify for separating performance obligations?

We agree, to an extent, with this proposal.

Once a group of performance obligations have been identified, we can see no benefit in the separate treatment of a sub-group of performance obligations that are fulfilled at the same time unless, as indicated in paragraph 4.56, there is doubt over the independence of the deliverables.

However, we are concerned that the practical application of this principle combined with the definition of a performance obligation might lead to a need to disaggregate complex longer-term projects (such as major design and build-type construction projects) into a far greater number of components that would currently be the case. This would not only increase the complexity inherent in accounting for such contracts but it might also increase substantially the risk of error, and the potential for manipulation, in the allocation of the transaction price to each of these performance obligations, particularly when that allocation is based only on an estimate.

Question 6: Do you think that an entity's obligation to accept a returned good and refund the customer's consideration is a performance obligation? Why or why not?

Tentatively, we do not think that an entity's obligation to accept a returned good and refund the customer's consideration is a performance obligation.

Although, as indicated in paragraph 3.37, it is likely that a customer would pay additional consideration for a right to return option, there are relatively few circumstances when such a right could be sold separately (paragraph 3.11). As such, in our view, the treatment of the right to return as a separate performance obligation would be inconsistent with the principles described in the Discussion Paper.

However, we do not consider the analysis of the matter or the proposed alternative treatments to be sufficiently developed to form a firm view on this question. We would recommend that the analysis be developed further and included in a further Discussion Paper, as suggested in our covering letter.

Question 7: Do you think that sales incentives (e.g. discounts on future sales, customer loyalty points and 'free' goods and services) give rise to performance obligations if they are provided in a contract with a customer? Why or why not?

Yes, we do think that sales incentives give rise to performance obligations if they are provided in a contract with a customer.

In both scenarios described in paragraph 3.27, treating the sales incentives as separate performance obligations would be consistent with the guidance in paragraphs 3.11 and 3.37. The separate treatment of the incentive offered by TuneCo (the 40CU gift card) would also be consistent with the proposed treatment of 'non-refundable' deposits described in Example 7 of appendix A (i.e. that revenue is recognised when control of the good or service has passed rather than by reference to cash payments).

The scoping of such arrangements would need to be clear, however. For instance, a producer of goods might sell to a retailer who would, in turn, sell to an end user. It is sometimes the case that sales incentives are offered by the producer directly to the end user (i.e. they are outside the producer's contract with the retailer but are integral to it). In such cases, without clear scope guidance, there might be a risk of inconsistent practice developing.



Chapter 4

Question 8: Do you agree that an entity transfers an asset to a customer (and satisfies a performance obligation) when the customer controls the promised good or when the customer receives the promised service? Why or why not? If not, please suggest an alternative for determining when a promised good or service is transferred.

The use of control as the trigger for revenue recognition has our broad agreement. It is consistent with the definition of a performance obligation discussed in our response to question 4. It is logical that, where performance obligations are identified from a customer perspective, the discharge of these obligations should be recognised once the customer has unconditional control over the good or has received the benefit of the service. In many cases, particularly in the provision of goods, the use of the control concept would be simple to apply and lead to consistent treatments.

However, we have reservations about the practical application of this concept to contracts for services and longer-term construction projects and sales with a right to return. There is, in our view, significant potential for the delay of revenue recognition (compared to current practice) due to the application of this principle to the former two types of contract and acceleration of revenue recognition for the latter. In addition it is possible that the use of the concept could become driven by the legal form of contractual arrangements compared to the more substantive approach of a 'risks and rewards' model without providing significant benefits in terms of either ease of application or quality of financial information. In consequence, we would urge the boards to ensure that detailed and clear application guidance is provided in this area.

Examples illustrating our reservations over the use of the control concept are:

- Paragraph 4.6 describes how "bill and hold arrangements" would be recognised as revenue when the customer can be shown to have control over the goods. We are concerned that the application of the control principle to such arrangements could give rise to an opportunity to recognise revenue even when there is no commercial substance in the sale. This might be the case, for instance, when a bill and hold arrangement is combined with a right to return as described in paragraph 4.11. It would appear that there would be nothing to preclude the recognition of revenue in such cases. In our view, this would be inappropriate and restrictions such as those described in paragraph 1 of the appendix to IAS 18 should be considered to restrict the structuring opportunities.
- We agree with the suggestion that a customer's intended use of the promised goods and service should not affect the point at which control is deemed to have passed (paragraph 4.25). However, we disagree with the implication of paragraph 4.30 ("...it does not matter that the customer does not intend to (or cannot) [our emphasis] use equipment X and Y without equipment Z..."). In our view, as discussed in our response to question 4, equipment X and Y should not be treated as separate performance obligations if their inoperability is due to the interdependence of X, Y and Z in terms of that equipment generally.
- The comment in paragraph 4.31 regarding the negotiation of contract terms affecting when a customer might take control of an asset is an example of when applying the control principle might miss the substance of the arrangement and lead to inappropriate revenue recognition.



- We agree with the suggestion that customer payment does not determine when an entity would recognise revenue (paragraph 4.32). However, the use of customer payments as an indicator of control as is also suggested by that paragraph may result in a legal form approach being adopted, disguising the substance of an arrangement. In our experience, contracts often refer to 'non-refundable' payments whereas, in reality, it would be rare for a customer not to have a claim for repayment in the event that the promised good or service is not eventually delivered. For instance, in the example in paragraph 4.37 (Customer payments cannot be recovered even if ConsultCo fails to provide the report), the customer would only have received the benefit of the services to date (and would, therefore, not have a claim on the 'non-refundable' payments) if the research resulting from the work to date was made available to them; the 'non-refundable' nature of the payments is not directly relevant.
- Similarly, the payment terms described in the example in paragraph 4.42 (MetalCo manufactures customised steel girders) are irrelevant to the transfer of control; that the customer can take possession of the work-in-progress at any time is the critical factor in that example.
- In some cases, for instance in the situation described in paragraph 4.42, it is difficult to envisage how a customer could practically exercise its right to take over the work in progress at any stage of the production process notwithstanding that they have the contractual right to do so. The simple insertion of a non-substantive 'access to work in progress' clause in a contract such as this might result in a material change to the pattern of revenue recognition.
- The application of the control principle to sales with the right to return might increase the volatility of revenue in a way that would not reflect the underlying transactions, particularly when applied to high value, low volume sales. Under the control principle such sales would be recognised as revenue on delivery, assuming that other contractual terms do not delay the transfer of control. Should the good be returned in a subsequent period, the reversal of the revenue would have the effect of reducing the 'true' performance for that period and could potentially lead to 'negative revenue'.
- The references to 'customisation' in paragraphs 4.43 and 4.48 and 'specific performance' in paragraph 6.20 are the only direct indications that control might be assessed other than by reference to physical access. This appears to be contradictory to the scenario described in Example 6 in appendix A (Boatbuilder) which indicates that control does not pass during construction as there is no right to access the work in progress. In our experience, few contracts for services and longer-term construction projects currently include a substantive access to work in progress clause and, in consequence, the use of a definition of control that requires physical access will have a significant effect on the revenue recognition in some industries.

With reference to this last point, we consider the level of customisation or uniqueness of an asset being delivered to be a key factor in determining when control passes. Using principles similar to those arising from the definition of a construction contract in IAS 11 would help to distinguish between the production of goods for which revenue should be recognised on delivery and the provision of a service for which revenue should generally be recognised as that service is performed.

Question 9: The boards propose that an entity should recognise revenue only when a performance obligation is satisfied. Are there contracts for which that proposal would not provide decision-useful information? If so, please provide examples.

We agree with the proposal that revenue should only be recognised when a performance obligation is satisfied. However, as indicated in our response to question 8, we have some reservations regarding when exactly a performance obligation is considered satisfied.



Chapter 5

Question 10: In the Boards' proposed model, performance obligations are measured initially at the original transaction price. Subsequently, the measurement of a performance obligation is updated only if it is deemed onerous.

- (a) Do you agree that performance obligations should be measured initially at the transaction price? Why or why not?
- (b) Do you agree that a performance obligation should be deemed onerous and remeasured to the entity's expected cost of satisfying the performance obligation if that cost exceeds the carrying amount of the performance obligation? Why or why not?
- (c) Do you think that there are some performance obligations for which the proposed measurement approach would not provide decision-useful information at each financial statement date? Why or why not? If so, what characteristic of the obligations makes that approach unsuitable? Please provide examples.
- (d) Do you think that some performance obligations in a revenue recognition standard should be subject to another measurement approach? Why or why not? If so, please provide examples and describe the measurement approach you would use.
- (a) Initial measurement of performance obligation

Yes, we agree with the Boards' proposal that performance obligations should be measured initially at the transaction price.

In addition to sharing the concerns regarding complexity and risk of error identified in chapter 5, we consider the current exit price approach to be inconsistent with the approach adopted for the identification and discharge of performance obligations. Throughout the Discussion Paper, the core principles are based on the goods or services that are promised to the customer and when those goods or services are transferred to the customer. Under the current exit price approach, as illustrated in paragraph 5.19, it would appear that revenue might be recognised in the absence of an identifiable performance obligation (e.g. revenue recognised in respect of contract acquisition costs) and, in consequence, in the absence of any discharge of an obligation.

(b) Identification and measurement of onerous contracts

Yes, we agree that a performance obligation should be deemed onerous and remeasured to the entity's expected cost of satisfying the performance obligation if that cost exceeds the carrying amount of the performance obligation.

As with our response to (a) above, we are supportive of the Boards' recommendation on the grounds of complexity and the associated costs and risk of error. We also share the concerns raised in paragraph 5.79; we do not consider it appropriate to recognise a profit on a performance obligation that is considered onerous.

In addition, we do not believe that the adoption of the cost approach would necessarily be inconsistent with the requirements of IAS 37. IAS 37.37 refers to amounts that would "rationally" be paid. Whilst in many circumstances the only available course of action might be to transfer the obligation or settle it in cash, another option may be available to the entity when considering its contracts with customers. In many cases, delivering the promised good or service to the customer at a loss might be the least-cost option available to the entity and, in consequence, will be the most rational course of action available to them. In such circumstances, we consider the cost approach would be consistent with the spirit if not the letter of IAS 37.



(c) Performance obligations for which the proposed measurement approach would not provide decision-useful information

Other than in some contracts that fall within the scope of the standards or proposed standards noted in our response to question 2 above, we have identified no performance obligations for which the proposed measurement approach would not provide decision-useful information.

(d) Performance obligations which should be subject to another measurement approach

Other than in some contracts that fall within the scope of the standards or proposed standards noted in our response to question 2 above, we have identified no performance obligations for which another measurement approach would be more appropriate.

Question 11: The boards propose that an entity should allocate the transaction price at contract inception to the performance obligations. Therefore, any amounts that an entity charges customers to recover any costs of obtaining the contract (e.g. selling costs) are included in the initial measurement of the performance obligations. The boards propose that an entity should recognise those costs as expenses, unless they qualify for recognition as an asset in accordance with other standards.

- (a) Do you agree that any amounts an entity charges a customer to recover the costs of obtaining the contract should be included in the initial measurement of an entity's performance obligations? Why or why not?
- (b) In what cases would recognising contract origination costs as expenses as they are incurred not provide decision-useful information about an entity's financial position and financial performance? Please provide examples and explain why.

As indicated in response (a) to question 10, we agree that all of the transaction price should be allocated to the identified performance obligations at contract inception.

In common with the recognition of other assets, we would consider it appropriate to include the incremental costs of acquiring a contract to be included in the initial measurement of the contract asset. Other non-incremental costs should, in our view, be expensed when incurred.

Question 12: Do you agree that the transaction price should be allocated to the performance obligations on the basis of the entity's stand-alone selling prices of the goods or services underlying those performance obligations? Why or why not? If not, on what basis would you allocate the transaction price?

Yes, we agree.

In our view, where an entity routinely sells goods or services separately, the prices for these transactions will provide the most relevant and reliable evidence for the allocation of the overall transaction price to the separate performance obligations. However, in our view, a certain level of sales activity would be necessary before this type of vendor specific evidence could be relied upon to be unaffected by abnormal transactions (i.e. small sales volumes would provide less reliable evidence of stand-alone value that commercial volumes).



Question 13: Do you agree that if an entity does not sell a good or service separately, it should estimate the stand-alone selling price of that good or service for purposes of allocating the transaction price? Why or why not? When, if ever, should the use of estimates be constrained?

Yes, we agree to an extent that if an entity does not sell a good or service separately, an estimated stand-alone selling price should be used. However, we would suggest that a hierarchy of methodologies be proposed such that, in the absence of acceptable vendor specific evidence of stand-alone sales prices (e.g. commercial sales volumes), an entity should make reference to the sales prices of similar goods or services offered by other market participants before relying on internally generated estimates.

Whilst we agree that it is unnecessary and, indeed, impracticable to mandate a method for estimating selling prices, should internally generated estimates be retained as an available option, we would recommend the inclusion of safeguards to prevent the inappropriate acceleration of revenue and profit recognition that might result from the use of estimates that cannot be corroborated by direct or indirect comparison to other commercial transactions. One safeguard that might be considered is to limit use of management's estimated selling price to situations where the stand alone selling price can be reasonably estimated.



Appendix 2 – Other comments on the Discussion Paper

Chapter 1

Paragraph 1.18 refers to the existing definitions of revenue in US GAAP and IFRSs which will be used in developing the new revenue recognition model. We note that paragraph 2.2 indicates that the term "ordinary activities" used in the IFRS definition is consistent with "ongoing major or central operations" referred to in US GAAP. In our view, the IFRS definition of revenue could be interpreted to include a wider range of income streams than would be possible under the US GAAP definition (i.e. those that do not result from the delivery of a product or service but which are nonetheless considered part of the entity's ordinary activities).

Chapter 2

Paragraph 2.10 states that the boards do not intend to preclude the possibility of an entity recognising revenue, in accordance with other standards, from increases in the value of goods being produced. We disagree with changes in the value of assets being presented as revenue. In our view, revenue should only arise when there is a contractual agreement to transfer the assets to a customer. No right to consideration arises though the appreciation of value of an asset, even when there is an active market. That right only arises when the transfer of that asset is agreed.

Chapter 3

Paragraph A12 suggests that the software and maintenance sold by SoftwareCo in Example 2 of appendix A are separate performance obligations even though the entity does not sell the software or support separately. We would agree with this conclusion on the assumption that the proper routine functioning of the software is not dependent on the provision of the maintenance service. As described in our response to question 4 above, where the two performance obligations are dependent on each other, and where there is no suitable substitute for the maintenance element, we would consider the two elements of the contract to be a single performance obligation.

Example 3 of appendix A describes how a 'standard' warranty would be considered a separate performance obligation. We agree with this in principle as it is consistent both with the guidance suggested in chapter 3 and with the treatment of economically similar 'extended' warranties. However, given that most goods would be sold with a 'standard' warranty that is either explicitly stated in the contract or implicit from the action of local law, we are concerned that the practical cost of treating it as a separate performance obligation would outweigh the benefits that it would bring. This is particularly the case in respect of high volume, low value goods.

Chapter 5

Appendix B illustrates a number of alternative approaches for the subsequent measurement of performance obligations. In all cases, the methods appear to add complexity and result in an increase in the volatility of revenue and profit recognition. In our view, in most cases, the most decision-useful information would be derived from the comparison of management's view of the value of each performance obligation (i.e. the allocation of the transaction price at contract inception) to the actual cost of delivering that asset over the period of delivery. The use of this method would show clearly and simply the success or otherwise of management's decisions through the variation in profitability from period to period.



Chapter 6

Paragraph 6.13 suggests that the Boards' proposed model could result in the recognition of revenue when collectability is not reasonably assured. Whilst we acknowledge that the board is yet to form its view on the measurement of the transaction price, we would generally not be supportive of the recognition of revenue in such circumstances.

Paragraph 6.47 suggests that, for many contracts (particularly for common retail transactions), the proposed revenue recognition model would cause little, if any change. Whilst we agree with many of the proposals outlined in this Discussion Paper, we are of the view that the suggested treatment of 'standard' warranties may have a significant affect on common retail transactions and the concept of revenue recognition on the transfer of control may have a significant affect on common contracts for services. Many retail products include a limited life warranty that, under the Discussion Paper's proposals, would the separated out and separately recognised as revenue. In our view this would not be reflective of the substance of these arrangements which, in many cases, are little more than a guarantee that the primary asset is of saleable quality.